The Federal Income Tax

IN ITS RELATION TO

Life Insurance Companies

BY

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LIFE INSURANCE COMPANIES.

In the debates upon the proposed income tax law which took place in the House of Representatives on the sixth and seventh days of this month (May, 1913) the points most discussed were not, as might have been expected, the advisability of an income tax nor the general scheme of rates and deductions. The one question upon which there seemed to be the most divergence of opinion and which received more attention in the debates than any other was the effect of the law upon mutual life insurance companies. The question is important as there are some 6,000,000 policy-holders in such companies who would be directly affected by any tax upon the corporate income. A large number of petitions, letters and memorials in favor of the entire exemption of mutual life insurance companies were presented. The chief argument advanced in favor of such exemption was that mutual life insurance companies should be placed in the same category

as mutual savings banks and fraternal insurance companies which are exempted. The answer to this was that the mutual companies made large profits which should be treated as income and that the corporation tax law, which is now practically merged in the federal income tax law, had provided for a tax on such profits. The contention in favor of total exemption did not appeal to the majority of the House, but there was another question which gave rise to a great deal of animated discussion and is likely to be a subject of controversy when the bill reaches the Senate, viz:

ARE POLICY DIVIDENDS INCOME?

The varying views which arose as to whether the so-called dividends returned to policyholders by mutual life insurance companies should be treated as a deduction from gross income may be classified under three heads:

1st. That such "dividends" should be deducted on the ground that they were simply returns of overcharges.

2nd. That the whole of the dividends paid to policyholders should be included in income, on the ground that they represent profits.

3rd. That so much of the dividends as represented return of premium payment should be deducted; but so much as represented net earnings or profit should be taxed.

The first and second contentions are clearly unten-

able, as the following analysis of the account with an ordinary policy in a mutual life company will show:

Age 38, 20 Payment Life, $2,500, issued 1904. Gross premium $100.85, Net premium $79.35, Loading $21.50. American Experience Mortality Table with 3% interest. Illustration of Dividend Account at end of 9th year, in 1913.

Dr.

To Loading	$ 21.50
" Mortality, as per table	21.95
" Reserve, 9th terminal	602.08
" Dividend	24.28
	$669.81

Cr.

By Reserve 8th terminal	$526.50
" 9th premium paid	100.85
" Interest on Reserve 3%	18.18
" *Salvage on Loading*	8.89
" *Salvage on Mortality*, 24%	5.28
" *Surplus interest on reserve* 1.6%	9.70
" *Interest on Loading salvage* 4.6%	.41
	$669.81

It will be seen from the above (which is an actual, not an assumed case) that the last four items on the credit side exactly equal the amount of the dividend on the debit side and constitute the elements of which it is composed. If we consider these elements separately it will appear that:

1st. *Salvage on loading* (for expenses) is not earnings or profit, but simply a return of principal or capital. The company, out of abundant caution, required the payment of a larger premium than was necessary, it being understood, however, that if the expenses proved less than had been estimated then the surplus would be returned. This is not income to the

company because it is refunded. It is not income to the policyholder because (although wrongly termed a dividend) it is a mere refund of money temporarily advanced by him to the company.

If the *policyholder* were permitted to deduct the amount of premium paid on his life insurance in the first instance as a legitimate business expense, then of course, in the administration of the income tax, it would be necessary to treat this refund as income to *him*. Although it is called a "salvage" it is, strictly speaking, not an amount saved. To illustrate: A man making a trip to New York might provide himself with $100 for traveling expenses and upon his return find that he had spent only $75. It does not follow that he has saved $25. He did not expect to spend $100 and only took the extra $25 to provide for emergencies. In like manner it might be said that the mutual insurance company did not expect to spend the whole amount of the premium required. It "loaded" it enough to provide for any extraordinary expenses which might occur and then returned the amount not used.

2nd. *"Salvage on Mortality"* is not profit or earnings if refunded to the policyholder and should not therefore be treated as income. The insurance companies very wisely provide for a heavier mortality than actually occurs. It is realized that war, pestilence, floods, earthquakes or other far-reaching catastrophies might at any time produce an excessive mortality which the company must be prepared to meet. But when the year has ended and it is found that the number of deaths has actually been less than the mortality tables provide for, then there is a considerable sum of

over-paid premium which, in the case of a mutual company, can be safely refunded to the policyholder. The premiums which grant the insured participation in the profits, are always loaded, the "loading" amounting usually to a fixed percentage of the net premium.

3rd. *Surplus interest on reserve.* The "terminal reserve" is defined by the Wisconsin law as the "reserve at the end of the policy year, and is the sum sufficient, with the premiums coming due, to provide for the future expense and mortality charges and mature the policy according to its terms, all computed upon the *expense charges* assumed, the table of *mortality* adopted and the *rate of interest* assumed." The interest required on the reserve in Wisconsin is 3%; but in the case of the policy mentioned above as an example the interest actually earned was 4.6% so that, at this point, we reach something which is clearly earnings, profit, or income and should be taxed as such whether it is retained by the company, or in the case given, is returned to the policyholder. As a matter of convenience it is much simpler and easier to collect the tax on the aggregate sum in the hands of the company than to follow it into the hands of the policyholders. In the policy account given above, moneys which have been paid in by the person insured and used as reserve have earned more than was needed for purposes of insurance and the surplus earning is refunded.

4th. *Interest on loading salvage.* As in the last case above this amount is clearly income. In the example given the policyholder practically loaned the company $8.89 for one year at 4.6 per cent and received the amount back with 41 cents interest.

The example above illustrates the important principle so often overlooked in the discussion of this subject, that capital utilized in insurance may at the same time be employed in the production of wealth. It is often claimed that premiums paid for life insurance are not an investment, but that statement is clearly incorrect in the case of participating policies.

It may be, and usually is true that the primary object of insurance is provision for the future; but this involves certain forms of investment which almost invariably yield more income than is absolutely needed for insurance purposes. In the example given above the policyholder paid a premium of $100.85, of which sum it was found that $14.17 was not needed and it was therefore returned. There were also surplus interest earnings to the amount of $10.11 which were not required and were therefore paid over to the policyholder.

In the case of a stock company with non-participating policies, there would be no refund and the surplus interest earnings would be applied to dividends on the stock and increase of reserves and surplus.

EFFECT OF THE TAX ON THE POLICYHOLDER

It is estimated that the average life insurance policy is for an amount between $2,000 and $2,500, and the example given above refers to a $2,500 policy with earnings perhaps a little greater than the average. The effect of the proposed income tax upon the policyholder would be that the company would be required to pay a one per cent tax on the net earnings, ($10.11) or ten cents, and the amount of loading refunded the

next year might be reduced to that extent. It will thus be seen that the burden of the tax, so far as small policyholders are concerned, will not be very heavy.

Considerable confusion has arisen in the public mind as to how the tax on insurance companies is to be assessed and collected. It is suggested that the policyholder who does not have $4,000 of income ought not to be called upon to pay the tax nor to make an affidavit as to his income.

While the law is not quite as clear on this point as might be wished, its general purpose seems to be to treat insurance companies exactly as other corporations are treated. They can deduct from gross income all sums paid as losses, all expenses and all sums necessarily applied to reserves. Upon the net income or earnings a tax of one per cent is levied. It is assumed for the purpose of income taxation that the policyholder in a mutual insurance company stands in the same relation to the company that a stockholder in any ordinary business corporation does to the company in which he holds stock. The question of whether he has an income of $4,000 or not is not raised. The government looks to the corporation for its tax and is not concerned whether the men who compose the company are stockholders or policyholders. That the *policyholder* is not required to make a return of the income derived from dividends would seem quite clear from that portion of paragraph D of the law which reades:

"Persons liable only for the normal income tax shall not be required to make return of the income derived from dividends on the capital stock, *or from the net earnings * * * of insurance companies taxable upon their net income as hereinafter provided.*"

It is precisely *because* the policyholder is not

charged with the tax that the company should not be permitted to deduct the full amount of the so-called dividends paid, any more than an ordinary business corporation should be allowed to deduct as a legitimate expense the dividends paid to its stockholders. In other words, the eventual *distribution* of profits must not be treated as if it were one of the *expenses* of making such profits. But it will be urged that the dividends are not wholly profits, but are partly refund, and such refund should not be treated as income. This is true, but the answer is that a refund is not a dividend though it may be called by that name. As was said in the case of Mut. Life Ins. Co., v. Commonwealth (128 Ky. 174,) "the law looks below the mere appearance of things and has regard to the reality." Money refunded is not "received" and should not be treated as income whether the refund is made immediately or at a later period. As a bookkeeping proposition it is immaterial whether the insurance companies charge themselves with the gross amount of premiums and then deduct the refund as an expense, or charge themselves with only the amount received *and retained*, treating the remainder as a mere over-payment which can not be regarded as income. In view of the decisions of the courts as to what constitutes "dividends" it would seem that the latter method would be the more appropriate.

WHAT THE COURTS HAVE HELD

It is often contended that the courts have held that dividends to policyholders are not income and cannot be taxed . A more accurate statement would be to say that the courts have held that money only constructive-

ly received should not be treated as income. An analysis of some recent decisions will make the distinction clearer. Of course, it would be impossible in the limits of this paper to discuss all the varied phases of insurance with which the law has to do and only a brief reference to three decisions affecting dividends will be attempted.

It will be remembered that the Corporation Tax Act of August 5, 1909, (Section 38) provided that "every insurance company shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such insurance company equivalent to one per cent upon the *entire net income* over and above $5,000 *received by it* from all sources during such year." Among the deductions permitted were "the sums *other than dividends,* paid within the year on policy and annuity contracts," etc. As identically the same words in respect to deductions (but with the comma omitted) are used in the proposed federal income tax law, the legal construction placed upon these words by the courts becomes important.

A. Decision of the Internal Revenue Department.

The question first arose before the Commissioner of Internal Revenue. Numerous hearings were held during a period of six months and in December 1911, the Commissioner rendered a decision to the effect that, under the terms of the law, dividends could *not* be deducted. This was not quite equivalent to saying that dividends were income although the practical result was to include such sums in net income. It would hardly be claimed for example that family and per-

sonal expenses are necessarily net income because they cannot be deducted in making out an income tax return. They might be paid out of accumulated capital.

In the hearings before the Commissioner the main arguments advanced by the insurance companies were:

First. That dividends declared by mutual and participating companies are not dividends in the commercial sense of the word, but are simply refunds to the policyholder at the time the annual premium of the policy contract is collected which over-charge is merely held in trust by the company issuing the policy.

Second. That even if it were conceded that dividends paid to the policyholders *in cash* were dividends within the intent of the statute it did not follow that dividends which were applied:

(a) To the payment of renewal premiums,

(b) To shorten the endowment or premium-paying period

(c) To purchase paid-up additions and annuities,

belonged in the same category and should be treated as income.

The reply of the Commissioner to the first contention was that the law clearly prohibited the deduction of dividends, that the companies had always treated such sums in their literature and otherwise as dividends; that Congress evidently had in mind the same thing that the insurance companies had been designating as dividends and that whether such dividends are dividends in the commercial sense or not they constitute what Congress specifically prohibited from being deducted.

In answer to the second contention, which was the

one most strenuously insisted upon by the insurance companies, the commissioner maintained that the dividends which were the property of the policyholders, upon being transferred to the company by direction of the policyholder, became income and the credit given did not constitute such a counter-payment as to entitle it to be treated as a deduction.

In accordance with these views the Commissioner ruled that no deduction should be allowed on account of dividends.

B. Decision of the United States Circuit Court.

The Mutual Benefit Life Insurance Company, having been compelled to pay a large sum under this ruling, paid the same under protest and brought suit in the United States District Court for the District of New Jersey to recover the amount thus paid. It should be noted, however, that the case (Mutual Benefit Life Insurance Company vs. Herold, 198 Federal Reporter 199. July 29, 1912,) did not involve cash dividends actually paid to policyholders, but only the dividends (a), (b) and (c) referred to in the second contention mentioned above.

The decision is quite lengthy and composed largely of citations not all of which appear to support the position taken. The peculiar angle from which the subject was viewed by the court may be seen in the following extract from the decision:

"In seeking to ascertain the intention of Congress, it seems but reasonable to assume, in the absence of anything to the contrary, that it uses the word "dividends" as applied to insurance companies in the sense it had long and generally borne in insurance matters which sense had moreover been confirmed by repeated judicial decisions. The term should, in other

words, be given what might not inappropriately be called its trade signification. Hence when it refers to dividends "paid" it means dividends paid and not an application of excess premium payments in abatement or redemption of subsequent premiums. The word "paid" as used by Congress, is highly significant. It clearly shows that it had cash payments in mind. It should be held to mean dividends which have been paid in cash during the year and repaid to the company as premiums. * * * Such a construction of the act in nowise contravenes its purpose which *was to subject to taxation cash dividends,* which, as statistics show, form a very large item in insurance business."

At the risk of seeming presumptuous we may venture the suggestion that the object of the act was *not* the taxation of cash dividends, but the taxation of net earnings; and further that the question of whether or not dividends are deductible from gross income hinges more upon the elements which make up the dividend than upon the form of payment.

It will require an unusual degree of ingenuity to reconcile the decisions cited in the above case with the conclusion arrived at, or, for that matter, with each other. This is illustrated by the following extracts, (the italics being ours):

"Such return of over-payments, whether in cash *or by application on future premiums, or by increase of the amount insured, is a dividend.* This is the meaning of "dividend" and the only meaning it has or can have in connection with mutual insurance."

Fuller v. Metropolitan Life Ins. Co. of N. Y. (Conn. 41 At. Rep. 4):

"Now the truth is that this overpayment (called dividend) is *not a dividend* in any sense of the term; nor is the failure of the company to collect the full amount of the premium in after years a credit in any sense of the term."

(Mut. Benefit Life Ins. Co. v. Commonwealth 128 Ky. 174.)

"The practice is to take an account every year of assets and liabilities and to give the insured the benefit of the surplus either by way of reduction of premium or by way of addition to the sum insured. *It can make no difference in principle whether the surplus is so applied or paid back in hard cash.* In either case it is nothing but the return of so much of the amount contributed as may be in excess of the amount really required."

Lord McNaughton, in N. Y. Life Ins. Co. v. Styles 59 L. J. Q. B. 291; L. R. 14 App. Cases 381, 1889.)

The cases cited are in substantial agreement that the amount paid as refund should not be charged as income, but many of the cases ignore the element of earnings. Upon that point the United States District Court has this to say:

"But it may be urged that the fund for (from?) which the so-called dividends are declared on mutual policies is likewise largely derived from interest on the company's investments, and that this shows that in a real sense such dividends are after all declared from the earnings, profits, or incomes of the company. This proposition might be entitled to weight were it not for the fact that in so far as the fund from which such dividends are declared is produced from interest on the company's invested funds, it has already been subjected to and has paid taxes under the act in question."

The fallacy of this argument lies in its assumption that the net earnings or income included in the dividends *had* been taxed. The Commissioner of Internal Revenue having ascertained that the company, in making its return for assessment for the corporation tax for the years 1909 and 1910, had deducted among other things all dividends allowed in reduction of re-

newal premiums and all dividends applied to purchase additional insurance or to shorten endowment terms, proceeded, with the approval of the Secretary of the Treasury, to amend the return for the years mentioned and levied an additional or supplementary assessment for the years in question the tax amounting (as to the two items of dividends mentioned above) to \$49,485.77. The taxes were paid under protest and suit was brought in the Supreme Court of New York to recover the amount thus paid. The suit was removed by certiorari to the United States District Court D. of New Jersey, where the decision was rendered. The Court held that the amount of tax paid, to-wit, \$49,485.77 should be refunded with interest from January 6, 1912, which was presumably the date when the tax was paid under protest.

It thus appears that whatever element of net earnings was represented by the dividends in question had been deducted. If it had not been there would have been no occasion for the supplementary assessment. This point can perhaps be made plainer by concrete figures. In the example which was given on page — ante, it appeared that \$10.11 of the dividend, or 41.6 per cent, was net earnings. Now, if the *tax* at one per cent amounted to \$49,485.77, the amount *assessed* must have been \$4,948,577, which proves to be the exact sum of the amounts reported by the company as "dividends in reduction of renewal premiums" received in 1909 and 1910. Assuming, for the sake of the illustration, that the dividends in question were composed of a corresponding proportion of earnings it would follow that 41.6 per cent of \$4,948,677 or \$2,058,608 of earnings embraced in the dividends were practically

deducted from gross income in making the original return. Therefore in the instant case the precise earnings in question had not been taxed until the attempt was made by the supplementary assessment.

It is unfortunate that the exact method of computation adopted by the company in making its return for 1909 and 1910 is not shown in the pleadings or opinions; but the following extract from the brief of counsel for the insurance company is significant and throws some light upon the point at issue:

"The question is whether the company's income in 1909, on account of renewed policies was $13,905,952 as claimed by the plaintiff (the Insurance Company) or $16,046,049 as claimed by the defendant (the Collector), the difference between these two sums, $2,140,097, being the amount allowed in abatement of renewal premiums; and whether in 1910 it was $14,270,488 as claimed by the plaintiff or $17,078,967 as claimed by the defendant, the difference between these two sums, $2,808,479, being the amount allowed in abatement of renewal premiums. These sums of $2,140,097 and $2,808,479 comprise the items set forth in plaintiff's Bill of Particulars as so-called dividends allowed in abatement of premiums, applied to the purchase of paid-up additions and to shorten the endowment or premium-paying term."

It may be conceded that the company did not receive in cash *from its policyholders* the full amount which was abated in the form of dividends. But the fact remains that the company had on hand the money necessary to pay the dividends. It offered to pay the sum in cash to its policyholders. Where did it get this money? Partly from overpayments of premiums and partly from earnings and such earnings were those of the taxing year. The company deducted the whole amount of dividends not by a formal deduction of such

moneys *as dividends,* but by charging itself with only so much of the premiums applied to renewals, etc., as was actually paid in cash, ignoring the sums which the policyholders directed them to apply to renewals. The result was exactly the same as it would have been if the company had charged itself in the year 1909 with gross premiums to the amount of $16,046,049 and then claimed a deduction for the dividends applied to renewals, etc., of $2,140,097, and in 1910 had charged itself with gross premiums to the amount of $17,078,-967, and then claimed a deduction of $2,808,479. The effect, in either case, would be to reduce the *net income* on which tax was eventually paid. So far as the element of *refund* in the dividends was concerned this course was not objectionable; but the element of *earnings* stands upon a different footing. It constitutes a part of the net income upon which the company should be taxed.

C. Decision of U. S. Court of Appeals.

It is somewhat curious that when the case was appealed by the Government the higher court fell into the same error. In fact it would seem to have been upon this point alone that the decision of the Circuit Court was sustained. The decision of the United States Circuit Court of Appeals for the third circuit (October Term 1912. No. 1693) as given on page 1211 of the Congressional Record, was as follows: Herman C. H. Herold, collector, v. Mutual Benefit Life Insurance Co., plaintiff below.

ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF NEW JERSEY.

Before Gray, Buffington and McPherson, circuit judges.

Per CURIAM:

Certain taxes for 1909 and 1910 were levied against the insurance company by two supplementary assessments under the act of 1909. The company paid under protest, and afterwards recovered judgment against the collector for practically the whole amount levied. Several questions were raised and decided below, but in this court only one question needs attention. Does the act tax the so-called "dividends" awarded annually to policyholders? The answer must be in the negative, unless such "dividends" form a part of the company's "net income * * * received by it * * * during such year." If they do not arise from income received during the tax year, but from income received during a previous year, Congress has not taxed them; or perhaps it is more correct to say, Congress has not taxed them more than once. Concededly, they have been taxed once with the other net income of the particular year during which the Company actually received them in cash; if, therefore, they are to be taxed more than once, it is well settled that the language imposing such an exceptional burden should be clear and unambiguous. But we need not discuss the subject; that duty has been performed by Judge Cross with such fullness and ability that we cannot do better than adopt his opinion. The case in the District Court is reported in 198 Fed., at page 199, and the discussion we refer to extends

from page 200 to page 212 inclusive. But we do not adopt what is said on page 212 concerning dividends on full-paid participating policies, nor what is said on the same page concerning stock companies; not because we wish to suggest disapproval, but merely because no opinion about these matters is called for now, as they do not seem to be directly involved.

The judgment is affiirmed."

A second error into which the Circuit Court fell in its discussion of the case seems to have arisen from its failure to note the exact wording and punctuation of the law. It will be remembered that the Court was greatly impressed with the fact that Congress used the words "dividends paid," and argued from this that only dividends actually paid in cash could have been meant. With all due deference to the learned court we venture the suggestion that that was not what Congress said and still less what it meant. Had the court consulted the original law as it appears in the United States Statutes at Large, it would have found that it reads thus:

"And in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity contracts." The phrase appears three times in the law and each time with the comma after the word "dividends." (See United States Statutes at Large, 61st Congress, 1909, 1911. Chapter 6, Section 38, page 113, lines 29 and 59 and page 115, line 7.) The Court may have been misled by the briefs as both sides erred in printing the sentence sometimes with and sometimes without the comma. In the printed brief of counsel for the Company in the Appellate

Court on page 21, the heading of the fourth contention, in large black letter type was as follows:

"From the Provision for Deduction from Gross Income of "sums other than dividends paid," there is no implication that Congress intended that Dividends Allowed in Reduction of Premiums should be included in Income."

In the argument which follows this heading it is said:

"This is the only mention in the Act(!) of the word 'dividends' in the insurance sense, and it is significant that it is coupled with the word 'paid' which plainly describes a cash transaction. This signification of the word 'paid' throughout the law is the chief ground for the 'cash basis' rule adopted by the court below and apparently unchallenged here."

But the law does not speak of "dividends paid." It speaks of "sums," "paid within the year on policy and annuity contracts" and dividends are expressly excepted from these sums. The phrase would perhaps have been clearer had it read: "the sums paid within the year, other than dividends, on policy and annuity contracts."

We are aware of the general rule in legal construction that the punctuation of an act or its title is not controlling for the purpose of ascertaining its real meaning. But it is equally well established that courts may give effect to punctuation in determining the true meaning of doubtful passages. A strong reason for giving the comma its full significance in this case is that only in this way can the sentence be made coherent and intelligible. If all the words following "dividends" are construed to relate to dividends then the word "sums" is left hanging in the air, unexplained

and unrelated to anything which follows or precedes. If however the words, "other than dividends" is treated as a parenthetical clause relating wholly to "sums paid within the year on policy and annuity contracts" we have a complete and intelligible statement, and one which may be fairly supposed to express the true intent of Congress that, in computing net income, dividends, as such, should not be deducted.

In what has been said of the decisions above there has been no desire to indulge in invidious criticism. We simply contend that these decisions fall far short of demonstrating in any satisfactory manner that dividends paid or credited to policyholders by mutual insurance companies should be deducted from gross income regardless of the extent to which they are made up of earnings.

Of course it is conceivable that there might be policy dividends which consist wholly of refund. If there are any such and the company had charged itself with the full amount of premiums in the first instance then in all fairness the company should be permitted to deduct such amounts whether they are called dividends or not. So too if a portion of the dividend is refund and the remainder earnings, the over-payment should not be treated as income. The principle is plain, but the practical application of the principle to the varied and complicated phases of life insurance is not free from difficulty.

It was decided by the United States Circuit Court in the Herold case that the returns of insurance companies should be made out on the cash basis. The wording of the law seems to justify this conclusion, but there are some obvious difficulties in making returns on that basis. If that plan were strictly followed the amount of premium with which a mutual company would charge itself would be the actual cash received in the form of premiums. Such amount would not include the sums allowed as dividends and applied on renewals, additions, etc. Of course it would follow also that such sums, not having been paid as cash, could not be allowed as deductions. Thus the sums applied in abatement would be entirely eliminated from the computation. But such sums are composed of two elements, earnings and refund. The earnings should not be deducted while the refund should. In a computation to determine what are net earnings the net earnings themselves should not figure. The distinction should be kept clear between expenses necessary to make the earnings and the distribution of the earnings after they are made.

While some of the companies have contended for the cash basis of accounting in connection with their returns under the Corporation Tax Law, we venture the suggestion that such a basis would work out unfairly in the case of every company which is increasing its business largely every year. The growth consists mainly in what is called "new business." Such new business is represented by payments of first premiums which are in cash and help to swell the item of

gross income. But, on the cash basis of accounting, the vastly increased liabilities which have been incurred will not appear as a countercharge. It may be suggested that this increase in liabilities would be taken care of by the "net addition, if any, required by law to be made within the year to reserve funds," which the law expressly permits to be deducted from gross income. But an examination of the annual reports of a prosperous company will show that a considerable margin would be left over. In one of the larger mutual companies the increase in the amount of insurance written and paid for in 1912 over the same item for the previous year was $14,970,476, while the net addition to reserve was only $14,023,144. The increase in premium receipts, which was over $3,000,000, was somewhat in the nature of an increase of capital consisting of borrowed money, and it is not perceived that the cash method of accounting would permit of any adequate countercharge.

In the case of a *stock* life insurance company the dividends paid to the stockholders would not be deductible from gross income. If the company is what is sometimes called a *"mixed"* company, or one which pays a fixed dividend to its stockholders and then distributes to its policyholders any surplus profits, such dividends could not be deducted from income. In such case the policyholder might be compared to the holder of common stock while the original stockholders have the preferred stock. But even in this case if any portion of the dividends to policyholders were returns of over-payments, such returns should be deducted from gross income.

In the Circuit Court decision cited above it was stated that the premiums paid to stock companies were not loaded. It is true that the loading in such companies is slight as compared with mutuals; but it is only necessary to compare the investment profits with total profits in such companies to see that there must have been a very substantial element of loading.

In a *mutual* company the distribution of its net earnings to its policyholders is a matter subsequent to the making and accumulation of such net earnings and that is true whether such earnings are paid in cash or allowed in abatement of renewal premiums, etc. Therefore we maintain that the refund element of dividends is the only element which ought to enter into the computation of net income and then only for the purpose of ascertaining the net amount of cash received from premium payments.

It will perhaps tend to make our position clearer if we present a very condensed account or return for a mutual insurance company in which it will be observed that dividends as such have no place. The sums used in this account are those given in the annual statement of a mutual company for the year 1911 with the exception of the amount of refunds, which is arbitrarily assumed to be 58.4 per cent of the dividends and the net addition to the reserve which is taken to be the difference between the legal reserve required at the beginning of the year and that required at the beginning of the next year.

RECEIPTS

Gross premiums	$40,421,263.23		
Less refunds	7,364,427.61		
		$33,056,835.62	
Interest and rents		13,422,949.48	
All other receipts		690,929.07	
			$47,170,714.17

DISBURSEMENTS

Claims by death	$10,830,204.59	
Matured endowments	2,838,559.37	
Annuities	71,322.62	
Surrendered policies	9,277,054.62	
Expenses (Commissions, salaries, taxes, etc.)	7,209,854.85	
Net addition required to be made to reserve funds including reserve for annuities	14,023,144.00	
		$44,250,140.05
*Net Income		$ 2,920,574.12

It is frankly conceded that the above method of computation would not answer in every case and possibly in no case without some minor modifications. It may serve however, as a tentative basis from which a workable formula may be devised, and it would seem to meet the requirements of the proposed Federal income tax law.

The objections which will probably be made by the insurance companies to this computation is that it is not on the cash basis in so far as it reckons as premiums money which was not received, to-wit, that portion of the dividends which was composed of earnings. Our reply is that this sum was in the hands of the company *in cash* ready to be paid to the policyholder, but the policyholder directed it to be applied toward his premium and the company carried out his direction and thus received the money. The

*It is interesting to note that in the case above mentioned the amount of insurance in force was $1,147,273,523, so that the income tax would amount to only *two and one-half cents* on each $1,000 of insurance.

roundabout method of paying the money to the policyholder and then having him pay it back would have attained exactly the same result.

As was said by the Commissioner of Internal Revenue in the Herold case above: "The contention that the company does not receive the amount of money belonging to the policyholder which is in the physical possession of the company, and which the policyholder directs to be taken and added to the amount which he remits and thus pay his premium liability, is, moreover, not acceptable as an accounting proposition."

IMPORTANCE OF CLEARNESS IN THE LAW

It is very important that the law should be so clear and explicit that no question as to its meaning can possibly arise. In the case of the Wisconsin income tax law more irritation and dissatisfaction were caused by certain ambiguous and complex provisions than by the actual collection of the tax. The average business man rightly feels that the law ought to be so plain that he can ascertain just what it requires of him without being compelled to resort to legal advice or litigation in the courts.

The proposed federal income tax law marks a new departure in our fiscal system and is in many respects a distinct advance upon any previous law on the subject. In so far as it breaks new ground it is totally lacking in precedents which would aid in its construction. The legal fraternity, the courts and people generally are not familiar with the subject of income taxation, and this emphasizes the importance of having the law very simple, direct and unequivocal in its phraseology.

It is extremely difficult to frame a law of this kind so as to meet every possible contingency and, when it is put to the test of actual operation, some defects and omissions will no doubt be discovered; but, so far as it goes, the public has a right to demand that it be expressed in simple and intelligible language. The department to which the administration of the law is entrusted will have quite enough to do without being called upon to solve problems essentially judicial or legislative in their character. Better a positive enactment which proves to be a mistake and has to be corrected by an amendment, than an ambiguous provision which is blind and confusing, leading to long-drawn out litigation, with conflicting decisions in different courts until the original intent and purpose of the law are lost in a maze of legal entanglements.

The framers of the proposed income tax law have evidently given the subject a great deal of painstaking study and have presented a measure which is much more carefully drawn than the average legislative enactment. Nevertheless it is not yet perfect and a number of amendments are still needed in order to make the exact intent and purpose of the act entirely clear.

AMENDMENTS TO THE LAW

(a) *As to dividends*:

The original bill, No. H. R. 10 provided (p. 146) that net income should be ascertained "by *deducting from the gross amount of the income* of such corporation, *received within the year from all sources,* all losses actually sustained within the year *and in the case of insurance companies the sums other than the amounts paid within the year on policy and annuity*

contracts to policyholders as dividends or as return of premium payments, and the net addition, if any, required by law to be made within the year to reserve funds."

It will be noticed that the last clause which appeared in four places in the bill was ambiguous in not showing what "sums" were meant, the words "other than" evidently governing all that followed.

As the bill was read in the House on May 6, the clause appeared in the following form: (p. 1206 Cong. Record.)

"And in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds *and the sums other than dividends or return of premium payments paid within the year on policy and annuity contracts."*

Subsequently the words "or return of premium payments" were stricken out so that the bill as it went to the Senate now reads:

"And in case of insurance companies the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts."

This provision is found in identically the same form on pages 152, 153, 156 and 157 of the new law and it is objectionable in so far as it repeats the language of the corporation tax law without the aid of the significant comma after "dividends." It is a phraseology which has given rise to expensive litigation and has resulted in decisions to the effect that only cash dividends can be deducted. As such a construction does not harmonize with the general intent of the

new law, it is to be hoped that the Senate will change the wording, or at least the punctuation of the sentence, so that no further doubts can arise as to its meaning. This could be done by putting the words "other than dividends" in parenthesis, or by adding a proviso along the lines of the one which immediately follows it in reference to mutual fire insurance companies.

(b) *As to proceeds of policies*:

There is also a latent ambiguity in the words "sums paid within the year on policy and annuity contracts," if only such sums are meant as represent repayment of principal.

As the bill was originally introduced, April 7, 1913, it provided (H. R. 10, pp. 134, 135):

"Net income * * * shall include * * * income derived from any source whatever, including the income from but not the value of property acquired by bequest, devise or descent, and also the proceeds of life insurance policies paid upon the death of the person insured."

As it was not clear from this language whether the proceeds of life insurance policies were to be deducted or not, the last clause beginning with "and also" was stricken out and the following proviso substituted:

"PROVIDED, That the proceeds of life insurance policies paid upon the death of the insured shall not be included as income."

Subsequently this provision was amplified so as to read as follows (H. R. 3321 p. 139):

"PROVIDED, That the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the

term mentioned in the contract, shall not be included as income."

This is the form in which the proviso is found in the bill now pending before the Senate and it should be noted: *First,* that this provision relates to ***individuals*** and not to *corporations; Second,* that the word "insured" where it occurs the third time should evidently be "insurer" as the contract is returned to the *company.* If however, the words "return thereof" refer back past the word "contracts" to "proceeds" then "insured" is correct. *Third.* The law refers only to payments made "at the maturity of the term mentioned in the contract."; *Fourth.* No distinction is made between profits and principal and the language is broad enough to cover both.

In the debate upon this paragraph (Cong. Rec. p. 1222) Mr. Stafford proposed to amend by adding after the word "insured" the words:

"Or amounts paid to the assured or his assigns in fulfillment or settlement of his policy contract."

This was suggested for the purpose of making it clear that policies surrendered would not be taxable. even though the surrender occurred prior to the"maturity of the term mentioned in the contract." In the discussion which followed Mr. Underwood gave it as his opinion that the law was broad enough to cover surrendered policies, but he was speaking about the "termination of the contract" which is quite a different thing from "maturity of the term mentioned in the contract." As there were several members who differed from him sharply on this point and, grave doubts were expressed as to the force and effect of the law, it would seem that some further amendment is

necessary. We venture to suggest that the words "at the maturity of the term mentioned in the contract" might well be dispensed with or at least the words, "in case of surrender, cancellation, or," could be inserted before "at" and another slight change made so that it would read:

"Upon the return of said proceeds to the insured in case of surrender, cancellation, or the maturity of the term mentioned in the contract."

In regard to the fourth point mentioned above it may be conceded that the provision on page 138 of H. R. 3321 in its final form does not apply to corporations and this brings us back to a consideration of what is meant by the words (pp. 151, 153, 156, 157) "sums" * * * "paid within the year on policy and annuity contracts."

It is quite clear from the discussions and debates in the House that the framers and sponsors of the proposed Federal income tax law intended to provide for a tax on the net earnings of mutual insurance companies and did not intend that any portion of the dividends or proceeds of policies should be deducted from gross income unless such portion represented refund or repayment of principal, and even then, only when it was definitely segregated from the other elements of the payment.

In his speech of May 1, Mr. Hull, who drew the bill, said:

"My judgment is that the accumulations of these companies, which arise from savings in expenses, savings in mortality, savings from lapses and surrenders. and profits from excess interest earnings, when considered in the aggregate, are clearly of such a character as to merit the payment of the

proposed tax. But when it is proposed to impose the tax, the question of premium overcharges is now brought up for discussion." * * * "If the companies would keep the question of premium assessments and overcharges strictly within a category to themselves and not mix and confuse them with the profits derived from the sources I have enumerated, I think it would then be possible for the law to deal with the one without affecting the other."

In the debate on the bill May 6, Mr. Hull said:

"No part of the principal invested in insurance which comes back to the insured during life is considered taxable income any more than the return of money which he might have loaned to another or a deposit that he might have made in the bank."

"The amendment which was adopted includes the proceeds of life insurance policies paid on the death of the person insured and also includes the return of any and all sums which a person invests in insurance and received back at one time or at periodical times during his life as distinguished from any actual gains or profits which he derives out of the investment."

In the debate of May 6, (p. 1224 Cong. Record) Mr. Underwood made the following statement in reference to surrendered policies:

"When that policy is returned there may be a portion of it that is principal and a portion of it that is profit, and probably there is. Under that contract they will return the principal and they will return some of the profit. Now the principal returned under the amendment that we adopted this afternoon will not be taxed. But if there is a profit returned it will be taxed."

* * *

"MR. TREADWAY. Mr. Chairman I would like to ask the gentleman from Alabama for a little further explanation of his definition. I understood him to say at the beginning of his remarks that there would be no

tax on an insurance policy on termination of the contract.

MR. UNDERWOOD. I did not say exactly that.

MR. TREADWAY. I thought those were the words that the gentleman used.

MR. UNDERWOOD. No; I said there would be no tax on the principal that was paid back to the insured at the termination of the contract, but that there would be a tax on the profits.

MR. TREADWAY. Yes, I understood that, but you did, use the expression 'on the termination of the contract.' Now, I would like to go a little further as to the meaning of 'termination of the contract.' For instance, if you have a 20-year endowment policy, and, as the gentleman from Wisconsin (Mr. Stafford) is suggesting, you desire to surrender it and get the cash surrender value, do you consider that as the termination of the contract?

MR. UNDERWOOD. Unquestionably.

MR. TREADWAY. In other words, if the policy has run 15 years, and you took the cash surrender value, there would be no tax on the principal of that policy at the end of the 15 years?

MR. UNDERWOOD. "Unquestionably there would not be."

The above quotations are amply sufficient to show a general intent to tax net income and not to tax return of principal. But it must be kept in mind that the real question is not so much whether the net income of life insurance companies shall be taxed, as it is, how shall the net income be determined. As the law now stands it provides that in the case of corporations net income shall be ascertained by deducting from the gross income:

1st. Ordinary and necessary expenses.

2nd. Losses.

Under the second head there is a special provision

that in the case of insurance companies there may also be deducted:

(a) The net addition, if any, required by law to be made within the year to reserve funds;

(b) The sums other than dividends paid within the year on policy and annuity contracts.

It will be noticed that there are no qualifications on "sums" * * * paid on policy and annuity contracts" other than the express exception of dividends and the limitation to the taxing year. The law does not say: "that part of sums, other than dividends, paid within the year on policy and annuity contracts, *which represents repayment of principal.*" From what was said in the debates one might suppose that the law made some such provision, but we fail to find any statement of that sort and venture the opinion that the law in its present form suggests the proper construction, viz: that the whole of the "sums" referred to shall be deducted from gross income. To read into the law a requirement that only repayment of principal should be deducted would lead to many difficulties and complications. This may be illustrated by the following concrete examples:

A. insures his life December 15, 1913 for $2,500 paying first premium of $100. He dies December 16 and his widow receives $2,500 in settlement of the death loss December 30. The company suffers a net loss of $2,400, but in making its return for the year 1913 it would charge itself with $100 of premium and deduct $100 as repayment of principal. The $2,400 is paid out of the reserve funds accumulated chiefly in previous years. Such funds in so far as they have been increased by net earnings have already paid taxes four years under the corporation tax law.

B. had a paid-up 20-year policy of $10,000 the last payment having been made in 1912. He dies December 16, 1913, and the death loss is paid December 30, 1913. It appears that he has paid $5,500 in premiums and the remainder necessary to pay the policy in full was accumulated and set aside wholly out of earnings made prior to 1913.

C. has an annuity of $500 for life. He bought it five years previous paying $7,500. The company has accumulated some earnings on the principal, a portion of which has already been taxed as net earnings. If the man dies within ten years it may be said that all payments to him have been made out of principal. If he lives to a great age his annuity may exhaust both principal and accumulations and the contributions of other annuitants will have to be drawn upon to keep up the payments.

D. has carried an ordinary life policy of $5,000 for 50 years and his net payments in cash have aggregated $6,500. There is also a sum nearly as large which has come into the hands of the company as interest increments on the annual premiums compounded for 50 years. When the company pays the death loss of $5,000 how shall it be determined whether the payment is made out of principal or interest earnings, either sum being more than sufficient for the purpose?

The cases cited above are only a few of many which might be adduced, but they are perhaps sufficient to show that any attempt to differentiate profits or earnings from principal in respect to the proceeds of life insurance policies paid upon death, surrender or cancellation would involve many intricate problems.

The general scheme of the proposed income tax

law is to charge individuals and corporations with the amount of gross income received during the taxing year and to credit them with such expenses and losses as are necessarily incidental to the business of that year. The payment of losses is a necessary expense of the companies regardless of where the money comes from. If no losses were paid there would soon cease to be any premiums. The losses may be presumed to be paid out of the net reserve which has been built up from the premium payments and interest earnings of former years and not from earnings of the taxing year.

It will not do to say that all proceeds of policies which do not represent refund of premium payments are earnings which ought to be taxed as income. Such a theory would confuse *property* with *income*. The reserve which the company carries and which it had on hand at the beginning of the taxing year is usually sufficient to pay all losses incurred during the year. If it were not, recourse could be had to the "net addition to reserve funds" (or more accurately the addition to net reserve) which the law expressly permits the company to deduct from its gross income.

But, at this point the question may be asked: Would not the same reasoning apply to dividends? We contend that it would not because the earnings comprised in dividends are the earnings and profits of the taxing year paid over or credited to the policyholder in substantially the same manner that dividends are paid to stockholders in an ordinary commercial corporation. The surrender value of the policy is the policyholders' capital held in trust for him by the company. The net annual earnings of that capital are income. As President Hadley once said: "Capital is a static con-

ception independent of time; income a dynamic conception involving the element of time."

This conforms to the theory which seems to have been adopted by most European countries, viz: that gifts, inheritances and proceeds of life or accident insurance policies are mere accessions to capital and in no sense income. They lack the elements of continuity, regularity and annual recurrency which are characteristic of income.

Thus the Prussian law provides (Einkommensteuergesetz, Section 7) that extraordinary receipts from inheritances, gifts or life insurance shall not be treated as taxable income, but as accessions to capital. The *income* however, of gifts, inheritances and life insurance are held taxable. Even a winning in a lottery is held to be an addition to capital and not income.

In Bavaria the new law which went into effect January 1, 1912, provided that gifts, proceeds of life and accident insurance, proceeds of sales of property, winnings in lotteries and other extraordinary and unusual receipts should not be considered income, but increase of capital. If however, the individual makes a business of selling property or speculating in lotteries then the receipts from such sources lose their exceptional and extraordinary character and are treated as income. Similar provisions may be found in the laws of Austria, Sweden, Denmark and several other countries and states.

SHOULD LIFE INSURANCE COMPANIES BE SUBJECT TO THE INCOME TAX?

In regard to the general argument that life insurance companies should be entirely exempted from the Federal income tax, even though they make profits, because the provision for the future involved in life insurance is something which ought to be encouraged, there are a few important considerations which should not be overlooked.

In the first place all capital and earnings are, in a sense, provision for the future, and a differentiation in favor of insurance savings is favoritism as against many other forms of saving designed to accomplish the same purpose.

In the second place it is no proper function of taxation to encourage the good and suppress the evil. As was well said by Judge Cooley:

> "A burden laid not for the purpose of producing revenue, but in order to accomplish some ulterior object which the government lacks the power otherwise to accomplish comes under no definition of the word "tax" which is recognized in public law."

It is true that this principle has often been violated in this country, as in the case of churches, which are exempt and saloons, which often bear excessive taxes; but every departure of this kind from the strict rule of equality disturbs the balance of the system and results in a certain degree of injustice. For that reason it may be questioned whether fraternal benefit companies, which sometimes have considerable reserves at interest, ought not to be required to pay the income tax on their net income. The assets of 396 fraternal insurance companies in 1911 reached the very respectable sum

of $148,000,000 and the amount of insurance in force was $9,839,000,000. The annual income account of such companies amounts to $130,000,000 and it would seem to be more consistent to tax them than to exempt the mutual companies.

In the third place the amount of income producing capital which is devoted to life insurance constitutes such a large portion of the wealth of the nation that its exemption must needs be justified by reasons of more than ordinary cogency. The admitted assets of 239 life insurance companies in 1911 reached the enormous total of $4,163,148,290. The total income for the year was $834,950,670 of which there was received in premiums $632,350,573 leaving apparent interest earnings to the amount of $202,600,097.

Assuming that these interest earnings are applied or used for the benefit of the policyholders, we have this situation: a class of people who are far from being the poorest in the country are asking to be exempted from the income tax on a four billion dollar investment which is yielding two hundred million dollars of interest annually because, forsooth, the investment is a wise and judicious one. One is tempted to use the words of Gladstone when it was proposed to exempt Ireland from the income tax:

"Let me remind the Committee what exemption means; it does not mean that we have got a bottomless purse, that we can dispense exemptions to one man without injuring another. No, sir. The exemption of one man means the extra taxation of another, and the exemption of one country means the extra taxation of another."

So in the present instance the investments in life

insurance can not be singled out for exemption without throwing a very considerable additional burden upon the investments of every other kind many of which are equally deserving of recognition.

In the fourth place the assumption that the Federal income tax of one per cent on the net earnings of life insurance companies will tend to discourage insurance in such companies would have more force if the amount of tax which will be required from small policyholders were not so insignificant. The relation between net earnings and amount of insurance carried is, of course, quite variable among the various companies; but, from the best information we have been able to obtain, it seems quite certain that the actual amount of tax which the companies will have to pay to the general government under the proposed new law will not exceed *five cents* for each $1,000 of insurance. No changes in *rates* are likely to occur by reason of the law. The policyholder will pay just what he has always paid, but the company, will recoup the amount of the tax from the surplus or possibly will allow a less amount as dividend in succeeding years. In either case the policyholder will not be made to feel the tax though in a very real sense the tax will be paid by him eventually.

But at this point we are met by the suggestion that insurance companies are already subjected to an excessive burden of taxation by the various states in which they do business and therefore ought to be exempted from the income tax. There is much force in this argument, but the fault lies with the states and not with the government. The abuses and injustices which have grown up in the attempts on the part of the states, by means of reciprocal and retaliatory legis-

lation, to control functions essentially national in character, present a striking commentary upon the futility of all such efforts.

The ideal plan would be to have the entire supervision and taxation of insurance companies placed in the hands of the Federal government so that fair and uniform treatment could be accorded to all; but the states will be very slow to give up such an important and productive source of revenue. The suggestion has been made that the Federal Government could act as an assessing and collecting agency and return the tax when collected to the states. Apart from the constitutional objections to such a plan there are grave difficulties which would arise in selecting any fair basis of apportionment.

In this connection it should also be remembered that an *income* tax rests upon an entirely different basis from the *property* tax and cannot be twisted and warped to meet every inequality and injustice of local laws. It often happens that real estate bears more than its just burden of taxes but the *income* of real estate will be taxed uniformly without reference to the inequalities of local taxation.

The income tax is proportioned according to ability to pay and the measure of ability to pay is the amount of income. The property tax measures the ability to pay by the assessed value of the property which the individual owns. The functions and methods of the two taxes are harmonious in some respects but divergent in others and no small degree of careful adjustment will be required to make them work effectively together.

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